



Bethany L. DiMarzio is an associate at Saxe Doernberger & Vita P.C. where she focuses her practice exclusively on complex insurance coverage for policyholders. Attorney DiMarzio currently serves as co-chair of the CBA Young Lawyers Section Insurance Law Committee.

# TEXAS SUPREME COURT'S INTERPRETATION OF THE CONTRACTUAL LIABILITY EXCLUSION: A VICTORY FOR POLICYHOLDERS IN THE CONSTRUCTION INDUSTRY

By Bethany L. DiMarzio

Over the past several years, Texas courts have interpreted and expanded the scope of the contractual liability exclusion in a standard commercial general liability policy. The typical contractual liability exclusion provides:

This insurance does not apply to:

**b. Contractual Liability**

"Bodily injury" or "property damage" for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement. This exclusion does not apply to liability for damages:

- (1) Assumed in a contract or agreement that is an "insured contract," or
- (2) That the insured would have in the absence of the contract or agreement.

In most jurisdictions, courts interpret the contractual liability exclusion to preclude coverage only in instances where the insured assumes the liability of another,

such as in a hold-harmless or indemnity agreement.<sup>1</sup> However, until recently, the holdings of two cases originating from Texas, *Gilbert Texas Constr., L.P. v. Underwriters at Lloyd's London*<sup>2</sup> and *Ewing Const. Co., Inc. v. Amerisure Ins. Co.*,<sup>3</sup> took the contractual liability exclusion too far, exposing policyholders to liability for claims that should be covered pursuant to most courts' interpretations of the scope of commercial general liability coverage. These cases posed a threat to policyholders both in Texas and nationwide, as insurers began to argue that other jurisdictions should follow the holding in *Ewing*, thus restricting coverage and exposing policyholders to liability that would normally be covered by their commercial general liability insurance.

**2010: Texas Supreme Court Expands the Exclusion in *Gilbert***

In *Gilbert Texas Constr., LP v. Underwriters*

*at Lloyd's London*, the plaintiff, Gilbert, entered into a contract with the Dallas Area Rapid Transit Authority ("DART") for construction of a light rail.<sup>4</sup> In the contract, Gilbert undertook an obligation to protect improvements and utilities on properties adjacent to the project and to repair or pay for any damages that did occur. As a result of flooding damage to an adjacent building, the property owner, "RT Realty" ("RTR"), brought suit against Gilbert and DART. Because RTR's only theory of liability against Gilbert was based on breach of contract, the court determined that Gilbert was not entitled to coverage. The holding in *Gilbert*, therefore, expanded the traditional interpretation of the contractual liability exclusion to include not only hold-harmless or indemnity agreements, but also contracts wherein the insured assumes any liability above and beyond that which is normally imposed by general principles of common law.

## 2011: Southern District of Texas Takes *Gilbert* Too Far in *Ewing*

In 2010, around the same time *Gilbert* was decided, the facts giving rise to a Southern District of Texas decision, *Ewing Const. Co., Inc. v. Amerisure Ins. Co.*,<sup>5</sup> were developing. In the underlying lawsuit, Tuloso-Midway Independent School District sought damages from Ewing Construction Company, Inc. (“Ewing”) for allegedly defective construction of a tennis facility pursuant to a contract between the school district and Ewing, and brought claims against Ewing sounding in breach of contract and negligence. Ewing was the named insured under a CGL policy issued by Amerisure Insurance Company (“Amerisure”). Amerisure did not dispute that the facts alleged in the school district’s complaint fell within the scope of the policy’s coverage agreement; however, it denied coverage to Ewing based on the policy’s contractual liability exclusion. Amerisure’s denial of coverage under the policy led to the *Ewing* action, wherein Ewing sought a declaration that Amerisure breached its duty to defend and indemnify Ewing in the underlying suit. Amerisure counterclaimed, seeking a declaration that it did not owe Ewing coverage under the policy on the basis that the policy’s exclusions precluded coverage.

In its analysis, the *Ewing* court first decided that, based on the allegations in the underlying complaint, there was coverage under the policy. The court then went on to discuss the applicability of the CGL policy’s contractual liability exclusion. Ewing argued that the exclusion did not apply, as it had not assumed any liability under its contract with the school district, and even if it had, the underlying complaint alleged theories of liability sounding in tort as well as contract, thereby entitling Ewing to a defense under the policy. The court, relying on *Gilbert*, found that the contractual liability exclusion applied not only to indemnity or hold-harmless agreements, but also to any instance where the insured assumes liability in a contract for bodily injury or property damage. The court concluded that “*Gilbert*, therefore, stands for the proposition that the contractual liability exclusion applies when an insured has entered into a contract and, by doing so, has assumed liability for its own perfor-

mance under that contract.”<sup>6</sup>

Turning to the facts in the underlying complaint, the court found that Ewing “assumed liability” for its own work on the tennis courts “such that it would be liable for failure to perform under the contract if that work was deficient.”<sup>7</sup> According to the court, this assumption of liability was evidenced by meetings between the school district’s superintendent and Ewing, wherein the superintendent stated that the tennis courts should last at least 25 years, with no demurrer from Ewing. The court found that Ewing assumed liability for its own work pursuant to its contract with the school district, and that coverage was therefore barred by the contractual liability exclusion. The court concluded that its holding was consistent with *Gilbert* and the case law relied on therein.

The district court’s holding in *Ewing* was noteworthy because it held that Amerisure was under no obligation even to defend a lawsuit that would otherwise be covered simply because the school district alleged causes of action based on the existence of a contract. Pursuant to the district court’s expansive interpretation of the contractual liability exclusion, policyholders would be forced to hire their own defense counsel and suffer immediate expenses at the outset of the claim in the absence of the bargained-for defense provided by the insurer. This result is contrary to the primary purpose of general liability insurance, which is to provide litigation insurance to insureds that face a multitude of claims on a regular basis.

## 2012: The Fifth Circuit Affirms

On appeal to the Fifth Circuit, Ewing argued that the district court’s reliance on *Gilbert* was misplaced, as *Gilbert* involved an assumption of liability for faulty workmanship performed under a contract, which is not the same as simply entering into a contract, as was the case in *Ewing*.<sup>8</sup> Ewing admitted that there was an assumption of liability in *Gilbert*, as the construction company promised to repair third-party property. However, Ewing argued that in this case, any implied promise to the School District to perform the contract with ordinary care was not

an assumption of liability, and that the contractual liability exclusion could not be triggered by the type of implied promises that are contained in every contract. The Fifth Circuit disagreed and affirmed the district court’s holding, stating that “[w]hether the breached promise was implied or express, the promise was of a contractual nature, all the same. We therefore hold that the CGL policy’s contractual liability exclusion excludes coverage in the instant case.”<sup>9</sup>

## 2014: Texas Supreme Court Reins in the Contractual Liability Exclusion

Less than two months after affirming the district court’s decision, the Fifth Circuit revisited the district court’s opinion in *Ewing Const. Co., Inc. v. Amerisure Ins. Co.*<sup>10</sup> After the Fifth Circuit’s initial ruling, Ewing petitioned for a rehearing, at which point the Fifth Circuit vacated its decision in *Ewing Const. Co., Inc. v. Amerisure Ins. Co.*<sup>11</sup> to certify questions to the Texas Supreme Court. In doing so, the Fifth Circuit stated that “[t]he correct application of this Texas precedent [in *Gilbert*] to the facts before us is unclear.”<sup>12</sup> The Fifth Circuit further recognized that Ewing’s contract with the school district, unlike the contract at issue in *Gilbert*, involved no undertaking of contractual liability above and beyond that which is common to all contracts. Because the *Ewing* case presented a disputed question of Texas law, the Fifth Circuit certified the following question to the Texas Supreme Court:

1. Does a general contractor that enters into a contract in which it agrees to perform its construction work in a good and workmanlike manner, without more specific provisions enlarging this obligation, “assume liability” for damages arising out of the contractor’s defective work so as to trigger the Contractual Liability Exclusion.<sup>13</sup>

On January 17, 2014, the Texas Supreme Court issued its ruling, answering “no” to the certified question and holding that the contractual liability exclusion does not apply to a standard breach of contract claim that alleges that the contractor failed to perform its work in a good and workmanlike manner.<sup>14</sup> In so holding, the Court indicated that the interpreta-

tion of the contractual liability exclusion in *Gilbert* would guide its interpretation, the circumstances in *Gilbert* were different than those in *Ewing*. In *Gilbert*, the policyholder had assumed the obligation to pay for damage resulting from a failure to comply with the requirements of its contract with DART, which was beyond Gilbert's obligations under general law and which caused the contractual liability exclusion to apply. The Court clarified that "[i]n other words, Gilbert did not contractually assume liability for damages within the meaning of the policy exclusion unless the liability for damages it contractually assumed was greater than the liability it would have had under general law—in Gilbert's case, negligence."<sup>15</sup> The Court further noted that the *Gilbert* case involved "unusual circumstances," given that Gilbert could ordinarily have been liable to RTR in negligence absent a contract, but under the facts of the case, the only basis for Gilbert's liability to RTR was Gilbert's breach of the contract with DART. Because there was no basis for Gilbert's liability outside of the contract, the exception to the exclusion did not apply.

Turning to the dispute between *Ewing* and *Amerisure*, the Court found that the phrase "assumption of liability" in the contractual liability exclusion "means that the insured has assumed a liability for damages that exceeds the liability it would have under general law. Otherwise, the words 'assumption of liability' are meaningless and are surplusage."<sup>16</sup> Furthermore, the School District's claims that *Ewing* failed to perform its work in a good and workmanlike manner were akin to simple negligence claims. Accordingly, the Court "conclude[d] that a general contractor who agrees to perform its construction work in a good and workmanlike manner, without more, does not enlarge its duty to exercise ordinary care in fulfilling its contract, thus it does not 'assume liability' for damages arising out of its defective work so as to trigger the Contractual Liability Exclusion."<sup>17</sup>

### Implications for the Construction Industry

Prior to the Texas Supreme Court's January 17, 2014 ruling, the *Gilbert* and *Ewing* cases posed a threat to policyholders everywhere, particularly those in the con-

struction industry. Contrary to the district court's opinion, the *Ewing* decision was not consistent with *Gilbert*, which was itself a liberal interpretation of the contractual liability exclusion. Rather, the district court's decision in *Ewing* was an unnecessary and unsupported expansion of the Texas Supreme Court's holding in *Gilbert*, where the contractual undertaking at issue was at least similar to the type of indemnity or hold-harmless agreement that is traditionally encompassed by the contractual liability exclusion.

Had the Texas Supreme Court answered the certified question in *Ewing* in the affirmative, and found that a contractor agreeing to perform its construction work in a good and workmanlike manner "assumes liability" for damages due to its defective work, the implications for the construction industry would have been drastic. Any contractor that performs work pursuant to a contract would have found itself potentially uninsured for any liability related to its work. Moreover, the impact of *Ewing* could have reached outside Texas, as many insurers have argued that the district court's decision should be applied in other jurisdictions.

The Texas Supreme Court's decision ends a hard-fought legal battle that initially saw two rulings in the favor of the insurer, but ultimately resulted in a victory for the policyholder. **CL**

## Notes

1. See, e.g., *Olympic, Inc. v. Providence Wash. Ins. Co. of Alaska*, 648 P.2d 1008 (Alaska 1982); *Haugan v. Home Indem. Co.*, 197 N.W.2d 18 (S.D. 1972); *Gibbs M. Smith, Inc. v. U.S. Fid. & Guar. Co.*, 949 P.2d 337 (Utah 1997); *Am. Family Mut. Ins. Co. v. Am. Girl, Inc.*, 673 N.W.2d 65 (Wis. 2004); *Federated Mut. Ins. Co. v. Grapevine Excavation Inc.*, 197 F.3d 720 (5th Cir. 2000).
2. 327 S.W.3d 118 (Tex. 2010).
3. 814 F. Supp. 2d 739 (S.D. Tex. 2011).
4. *Gilbert*, 327 S.W.3d at 118.
5. 814 F. Supp. 2d 739 (S.D. Tex. 2011).
6. *Id.* at 747.
7. *Id.*
8. 684 F.3d 512 (5th Cir. 2012).
9. *Id.* at 519.
10. 690 F.3d 628 (5th Cir. 2012).
11. 684 F.3d 512 (5th Cir. 2012).
12. *Ewing*, 690 F.3d at 632.
13. *Id.* at 633.
14. *Ewing Const. Co., Inc. v. Amerisure Ins. Co.*, No. 12-0661 (Tex. Jan. 17, 2014). The article "Construction Industry Policyholder Coverage in Upheaval After Ruling," authored by SDV attorneys Jeremiah M. Welch and Theresa A. Guertin, was cited in *Ewing's* brief to the Texas Supreme Court. In its ruling, the Texas Supreme Court agrees with the ultimate conclusion of that article: the contractual liability exclusion is not intended to exclude coverage for all breaches of contract.
15. *Id.*, slip op. at 10.
16. *Id.*, slip op. at 12.
17. *Id.*, slip op. at 13.

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